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April 25, 1997

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
Washington, DC 20554

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Federal Communications Commission
Office of Secretary

Re: CC Docket 96-262

Dear Mr. Caton:

We understand that AT&T and possibly other long distance carriers have raised certain arguments against the Commission implementing an approach to access charge and universal service reform that would (1) call for LECs to reduce per-minute access rates charged to IXCs, and (2) to recover the lost revenues from a pre-subscribed interstate carrier charge (PICC) that could be passed through, at the IXCs' option, to their customers.

The attached materials, a statement prepared by Professor Robert Crandall, of the Brookings Institution, and a legal memorandum prepared by Latham & Watkins, are intended to address the IXCs' arguments. We hope you find them useful.

Please do not hesitate to contact me should you have any questions. Thank you for your consideration.

Sincerely,

Robert T Blau

Robert T. Blau

cc: Chairman Reed Hundt
Commissioner Rachelle Chong
Commissioner James Quello
Commissioner Susan Ness

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April 25, 1997

Economically-Efficient Access Reform

Robert W. Crandall
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The Federal Communications Commission is currently struggling with proposals to reform the method of recovering the federal portion of local-exchange carriers (LECs) costs. The current system is extremely inefficient because it recovers nontraffic sensitive costs through per-minute access charges levied on interexchange carriers (IXCs). For some time, it has been clear that shifting this recovery mechanism towards nontraffic-sensitive charges <u>per line</u> would greatly enhance economic welfare primarily because it would reduce the marginal cost of interstate long-distance calls and therefore greatly expand interstate long-distance calling.

Among the proposals for reform are options to reduce per-minute access rates and to recover the lost revenues from either increased subscriber line charges (SLCs) to be assessed on business and residential subscribers or from pre-subscribed line charges (PSLs) to be paid by IXCs who would then pass them on to the final subscriber. In either case, the nontraffic sensitive costs of the LECs' networks would be more efficiently recovered on a monthly per-line basis as interstate access rates were lowered.

Apparently, objections have been raised to the imposition of a PSL on the theory that such a charge would unduly penalize long-distance services and reduce long-distance calling. This objection is misguided and can only serve to derail a promising avenue for reforming a decades-old regulatory mistake in the pricing of telephone services.

The objections to a PSL are that such a charge will unduly increase the cost of long-distance service, thereby reducing total long-distance calling. Presumably, this would occur because subscribers would weigh the additional per-month charge against the value of long-distance service, and some would choose not to subscribe to a long-distance service at all. But most variants of the PSL proposal do not allow subscribers to telephone service to avoid the PSL by dropping their long-distance carriers; the PSL would simply be levied by the subscriber's LEC in such a circumstance.

Would this version of a PSL reduce long-distance calling? The answer is clearly in the affirmative, but this reduction would be minuscule compared with the stimulus created by the lower per-minute access charges. An unavoidable PSL could only reduce long-distance calling by causing some subscribers to drop <u>all</u> telephone service and through an indirect "income effect." Both effects would be almost undetectable.

First, the effect of a $1 to $3 per month PSL would only be to raise the monthly price of telephone service by between 5 and 15 percent for residences and 2.5 to 7.5 percent for single-line businesses. Assuming price-elasticities of demand for local access lines of -0.03 for residences and -0.01 for businesses, the effect of a $3 PSL would be to reduce access lines by 0.45 percent for residences and by 0.075 percent for businesses. The effect on long-distance calling would be even less because those disconnecting from service would likely use their telephones for long-distance calls much less than those remaining on the network. Thus, the total direct effect of the PSL through reduced demand for access lines would be much less than even the 0.45 percent postulated maximum effect on residential lines.

The income effect of the PSL would be even smaller. Even a $3 per month PSL translates into only $36 per year or less than 0.2 percent of income per capita. Assuming 2.5 persons per household, a $3 PSL would reduce household income by less than 0.08 percent. Such a small reduction in household income would likely reduce residential access demand by even less than 0.08 percent. In short, the PSL would have virtually no indirect effect on telephone use through the income effect.

Finally, one might ask whether an avoidable PSL -- i.e., one that subscribers could avoid by discontinuing long-distance service -- might reduce long-distance calling. The only persons disconnecting from long-distance service under this option would be those who valued their service by less than $1 to $3 per month despite the substantial decline in the price of each call due to the lower per-minute access rates. Assuming that each $1 of a PSL would translate into a 16 percent reduction in per-minute access charges and that access charges comprise 30 percent of average residential interstate rates, each $1 in PSL would reduce residential interstate long-distance rates by 4.8 percent. Thus, a $3 PSL would reduce residential interstate long-distance rates by 14.4 percent, a sizable reduction. With these rate reductions, calling would increase by about 3.4 percent for a $1 per month PSL -- and very few residential subscribers now making long-distance calls would choose to discontinue long-distance service.

For instance, a residential subscriber who is making only one five-minute call per week at current rates would be spending about $4 per month today. The imposition of a $1 per month PSL would reduce this subscriber's cost of these calls by 17 cents per week and induce about two-thirds of a minute in additional calling. As long as this resident's current long-distance service delivers about $0.80 in consumer surplus above its $4 in monthly calling expenses, it would keep its long-distance service. Given the range of estimates of the price elasticity of demand for long-distance service, it is likely that most consumers with even this modest amount of calling would keep their service. Of course, residential subscribers who spend $20 or $30 or more per month on long distance are sure to retain their service.

In short, even if the PSL were structured to allow residential subscribers to avoid it by dropping long-distance service altogether, there is very little likelihood that many subscribers who currently use little long-distance service would drop their service altogether. It is reasonable to expect that each $1 per month of a PSL would reduce access rates sufficiently, if fully passed on by IXCs, to stimulate approximately a 3 percent increase in interstate long-distance minutes.

Rivalry among IX carriers would lead them to pass on a large share of both the flat monthly charges and the lower per-minute access charges. The additional competition from large-scale new entry, such as that now occurring in Connecticut or about to develop from RBOC entry into interLATA services, will assure that virtually all of these charges are passed on to subscribers. As per-minute access charges are lowered, IX carriers will offer lower rates to all classes of customers. The flat PSL charges will also be reflected as flat charges to subscribers because every IX carrier will incur these charges on a per-line basis. It would be unfortunate, however, if the FCC decided that new cost-based regulation was required to assure that the lower per-minute access charges were reflected in lower interstate long-distance rates. Given the changes in other costs, particularly the reductions in cost from technological progress, the Commission would have to launch a detailed investigation into IX carriers' costs and rates to determine whether the lower access charges were reflected in retail rates. This return to cost-based regulation and its attendant depressing effects on efficiency improvements should be avoided.

The improvements in economic welfare (consumer surplus) obtained by substituting a PSL for part of the current per-minute access charges would be substantial. I assume that there are about 500 billion minutes of interstate switched access per year, that current interstate conversation minutes are about 350 billion per year, that access rates average 2.7 cents on each end, and that interstate rates (business and residential) average 16 cents per minute. Furthermore, I assume that the average access line rate (business and residential) is $27 per month, that the price elasticity of demand for long-distance service is -0.7 and that the price elasticity of demand for local service averages -0.025. Under these assumptions, each $1 PSL leads to a reduction of 0.55 cents in access charges per conversation minute, or a 3.4 percent decline, which in turn increases long-distance calling by 2.4 percent. The welfare gains from a $1 per month PSL are about $24 million per year. With constant-elasticity demand functions this rises to about $240 million per year for a $3 per month PSL that would reduce access charges by about 1.1 cents at each end or, assuming 1.43 switched access minutes per conversation minute, by about 1.6 cents per conversation minute.

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MEMORANDUM REGARDING AT&T'S PURPORTED LEGAL OBJECTIONS TO A "PICC"

I. INTRODUCTION

In the context of its twin access charge and universal service proceedings, the Federal Communications Commission (the "Commission") is weighing various proposals to reform the method of recovering the interstate portion of local exchange carrier ("LEC") costs. It has been clear for some time that shifting this recovery mechanism towards non-traffic-sensitive ("NTS") per line charges "would greatly enhance economic welfare primarily because it would reduce the marginal cost of interstate long-distance calls and therefore would greatly expand interstate long-distance calling."[1]

Among the reform options being considered by the Commission is a proposal for LECs to reduce per-minute access rates charged to interexchange carriers ("IXCs"), and to recover the lost revenues from pre-subscribed interstate carrier charges ("PICCs") to be paid by IXCs, which could then, at the IXCs' option, be passed through by IXCs to their customers. We understand that IXCs have objected to this option, claiming that an attempt to pass-through PICC charges via a concomitant change in customer rates would be met with significant legal challenge by customers. AT&T argues, for example, that attempting to pass through PICC charges would violate terms in existing AT&T contract-based tariffs. We believe that AT&T's legal argument is without merit, and that the PICC proposal is a legally sound policy option for the Commission to adopt.

II. ANALYSIS

AT&T currently provides service to its customers pursuant to various types of interstate tariffs filed with the Commission that specify the rates, terms and conditions at which AT&T will provide different long distance services. In order for AT&T and other long distance carriers to better serve their high-volume business customers, the Commission has permitted these carriers to offer service to individual customers on a contract tariff basis, provided that similar terms are made available to other customers under substantially similar circumstances and conditions.[2]

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[1] Robert W. Crandall, "Economically Efficient Access Reform" (April 23, 1997).

[2] *See Competition in the Interexchange Carrier Marketplace*, 6 FCC Rcd 5880, 5897 (1991) (finding that allowing AT&T "greater freedom to enter into contracts with customers for business services will benefit

Although the Commission has decided that all long distance services should be mandatorily detariffed,[3] the *Detariffing Order* has been stayed pending judicial review -- ironically, at the long distance industry's request. Thus, the law of tariffs under the Communications Act has not changed, nor is it likely to change during the implementation of the Commission's access and universal service proposals, which is imminent.

As the Commission is aware, it is well established under the "filed rate" doctrine that where a filed tariff rate, term or condition differs from a rate, term or condition set in a non-tariffed carrier-customer contract, the carrier is required to assess on its customer the tariffed rate, term or condition.[4] Thus, if a carrier unilaterally changes a rate by filing a tariff revision, the newly filed rate becomes the applicable rate unless the revised rate is found to be unjust, unreasonable, or unlawful under the Communications Act.[5] In the recently-stayed *Detariffing Order*, the Commission proposed to detariff the IXC industry *precisely* because the filed rate doctrine provides carriers like AT&T with "the ability to alter or abrogate their contractual obligations in manner that is not available in most commercial relationships."[6]

The Commission historically recognized that a dominant carrier's proposal to modify extensively a long-term service tariff may present significant issues of reasonableness under Section 201(b) of the Communications Act that are not ordinarily raised in other tariff filings.[7] Thus, the Commission held that a dominant carrier's unilateral tariff revisions that alter material terms and conditions of a long-term service tariff will be considered reasonable only if the carrier can make a showing of "substantial cause" for the revision.[8] Under that test, the FCC

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consumers without increasing the risk of anticompetitive or other undesirable behavior by AT&T"). The Commission's authority to allow such contract-based tariffs was upheld in *MCI Telecommunications Corp. v. FCC*, 917 F.2d 30, 37-38 (D.C. Cir. 1990).

[3] Policy and Rules Governing the Interstate Interexchange Marketplace, Second Report and Order, 4 Comm. Reg. (P&F) 1199 (1996) ("Detariffing Order").

[4] *See Armour Packing Co.. v. United States*, 209 U.S. 56 (1908); *American Broadcasting Cos., Inc. v. FCC*, 643 F.2d 818 (D.C. Cir. 1980); *Detariffing Order*, 4 Comm. Reg. (P&F) at 1215 n.122, 1219, ¶55.

[5] *See* 47 U.S.C. § 201(b). *See also Maislin Industries, U.S., Inc. v. Primary Steel, Inc.*, 497 U.S. 116 (1980).

[6] *Detariffing Order*, 4 Comm. Reg. (P&F) at 1219-20, ¶55. *See also id.* at 1221-22 (observing that under permissive detariffing advocated by long distance carriers, Section 203(c) "may require the carrier to provide service at the rates, and on the terms and conditions, set forth in the tariff until and unless the carrier files a superseding tariff canceling, or changing the rates and terms of, the tariff").

[7] *RCA American Communications, Inc.*, Memorandum Opinion and Order, 84 FCC 2d 353 (1980); Memorandum Opinion and Order, 86 FCC 2d 1197 (1981), *aff'd* 731 F.2d 996 (memorandum opinion); Memorandum Opinion and Order, 2 FCC Rcd 2363 (1987), *aff'd sub nom. Showtime Networks, Inc. v. FCC*, 932 F.2d 1 (D.C. Cir. 1991).

[8] *RCA American Communications, Inc.*, 86 FCC 2d at 1201.

considers two factors in evaluating the reasonableness of carrier's tariff change: (1) the carrier's explanation of the factors demonstrating "substantial cause" for the change, and (2) the position of customers that rely on the carrier's tariff.[9]

The Commission has indicated that the "substantial cause" test applies to unilateral tariff modifications made by all long distance carriers, dominant or not.[10] In fact, the Commission has expressly adapted the test to AT&T's contract tariffs. In its order declaring AT&T to be non-dominant, the Commission stated that if AT&T files a modification to a contract-based tariff, "we will consider on a case-by-case basis, in light of all the circumstances, whether a substantial cause showing has been made."[11]

In this case, it has been proposed that AT&T be provided with the option of passing the proposed PICC through to its customers. In the event that AT&T modified its contract tariffs to do so, and the revision were subsequently challenged by a disgruntled business customer,[12] we believe that AT&T would have little difficulty meeting the "substantial cause" test.

In *RCA American*, the leading case (or set of cases) where a carrier successfully demonstrated "substantial cause," the Commission allowed increased rates to take effect on the basis of a unilateral carrier-initiated change because events "clearly unforeseeable" at the time the tariff was filed provided the requisite cause for the higher rates.[13] Here, the Telecommunications Act of 1996 has mandated sweeping changes to the Communications Act --

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[9] *Id.*

[10] Policy and Rules Governing the Interstate Interexchange Marketplace, Notice of Proposed Rulemaking, 11 FCC Rcd 7141, 7189 (1996) ("Detariffiing Notice") (citing *RCA American, Inc.*, 86 FCC 2d at 1201-02, *Competition in the Interexchange Marketplace*, Memorandum Opinion and Order on Reconsideration, 10 FCC Rcd 4562, 4573-74 (1995) ("1995 Interexchange Reconsideration Order")).

[11] *In the Matter of Motion of AT&T Corp. to Be Reclassified as a Non-Dominant Carrier*, 11 FCC Rcd 3271, 3342-43 (1996); *see also 1995 Interexchange Reconsideration Order*, 10 FCC Rcd at 4574 (Commission will consider on a case-by-case basis, in light of all the relevant circumstances, whether a substantial cause showing has been made that would permit a carrier to alter unilaterally the terms of a contract-based tariff). The Commission has noted that while contract law principles are relevant when applying the substantial cause test to a contract-based tariff, it has not been willing to agree "that those principles provide definitive parameters for a substantial cause showing." *1995 Interexchange Reconsideration Order*, 10 FCC Rcd at 4574. Application of the test continues to depend on "the equities of a particular situation." *Id.* at 4574 n.49 (citing *RCA American Communications*, 86 FCC 2d at 1201-02).

[12] We note, however, that the likelihood of such a challenge is itself questionable. Even if AT&T elects to pass the PICC through to its customers (and it may not), there should over time be a net decrease in the overall charges to AT&T's business customers as interstate access charges are reduced.

[13] *RCA American Communications*, 2 FCC Rcd 2363, 2368 (1987).

changes that have engendered the FCC's competition trilogy of interconnection, access charge reform, and universal service proceedings, and that will dramatically affect every carrier in the telecommunications industry. Like the carrier in *RCA American*, AT&T similarly can claim reliance on a dramatic "unforeseeable" event -- the very creation of the PICC -- that would justify a rate increase to its customers.[14]

Indeed, we believe that the Commission could make that very finding in its forth coming access charge reform/universal service orders. The FCC could specifically find that the unique circumstances surrounding the passage of the Telecommunications Act would warrant a finding at this time of "substantial cause" in the event that long distance carriers wished to pass the PICC through to their customers. If such a finding were made by the Commission, as set forth above, challenges to the contract tariff changes by AT&T's customers would be effectively foreclosed by the application of the filed-rate doctrine.[15] We therefore do not consider AT&T's claims to the contrary, as we understand them, to be credible.

Gary M. Epstein

James H. Barker

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[14] Indeed, it is likely that the actual contracts between AT&T and its customers would themselves allow for such modifications pursuant to a "force majeure" or similar contract provision.

[15] *See, e.g., FAX Telecommunicaciones v. AT&T*, 952 F. Supp. 946 (E.D.N.Y. 1996) (applying filed rate doctrine in conjunction with contract tariffs). We note that AT&T is currently engaged in a spirited attempt to invoke the filed rate doctrine to defend itself against state contract and tort law claims. *See Central Office Telephone, Inc. v. AT&T*, Nos. 94-36116, 94-36156, AT&T's Petition for Rehearing and Suggestion For Rehearing En Banc (9th Cir. Mar. 19, 1997).